After Greenspan: Whither Fed Policy?

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It is widely agreed that Alan Greenspan has been an outstanding Fed Chairman. Over the years ahead, Fed chairmen will surely want to extend Greenspan's record of policy success. But I ask this question: What are the characteristics of the Greenspan policy regime that have led to policy success?

As far as I know, there has been no comprehensive study of the characteristics of the Greenspan regime. To extend the regime will require an understanding of just what the regime is. My purpose is to outline some thoughts on that issue by discussing four key characteristics of the Greenspan regime. First on my list is low-inflation credibility—that is, market confidence that the Federal Reserve will conduct policy to yield low inflation averaged over any span of a few years. The other three characteristics of the Greenspan regime are successful crisis management, empirical understanding of the economy, and predictability of monetary policy. I'll comment on all four, but concentrate on predictability issues as these are, I believe, the most interesting of the characteristics of the Greenspan regime.

Before proceeding, I offer the usual Fed disclaimer—that the views I express do not necessarily reflect official positions of the Federal Reserve System. I thank my colleagues at the Federal Reserve Bank of St. Louis for their comments, especially Bob Rasche and Dan Thornton, but I retain full responsibility for errors.

LOW-INFLATION CREDIBILITY

Market confidence in the Federal Reserve's ability and willingness to maintain a low trend rate of inflation has been a core characteristic of the Greenspan regime. Greenspan did not achieve instantaneous market confidence when he took office in 1987, but built that confidence quickly during his initial years as Fed chairman.

Examination of current survey data and the spread between the yields on conventional and indexed Treasury bonds indicates that market confidence in continuing low inflation extends well beyond Greenspan's tenure as Chairman. Institutionalizing market confidence in the Federal Reserve is a great accomplishment. However, there is no doubt in my mind that in coming years the markets will be watching closely to see whether chairmen following Greenspan will maintain a low-inflation regime. In recent years, market confidence has been so great that only a string of poor policy decisions would have changed inflation expectations. For example, inflation expectations hardly changed in the aftermath of 9/11 and of the oil price increases of 2004-05.

The next chairman will start with a base of institutionalized market confidence, but the market will naturally be somewhat skeptical until the new chairman has established his or her own track record. Put another way, the Fed's inflation-fighting credibility may be somewhat more fragile over the next few years than it has been over the past few years. Almost certainly, future chairmen will address the issue of whether the Federal Reserve should adopt a formal inflation target, which many economists and a number of members of the FOMC, including me, have espoused.

SUCCESSFUL CRISIS MANAGEMENT

Effective crisis management is important not only for dealing with crises but also for instilling

market confidence in the Federal Reserve. I believe that the Federal Reserve has managed crises effectively throughout the post-World War II period, but its skills were certainly honed during the Greenspan years. The major crises during these years were the stock market crash of 1987, the financial market disturbance in the fall of 1998 following the Russian default and near failure of Long Term Capital Management, and the terrorist attacks of September 2001. The Fed prepared carefully for Y2K, and its preparations contributed to that event passing smoothly. Ahead of Y2K and especially following 9/11 the Fed invested heavily in stronger contingency arrangements for communications among policymakers and in infrastructure for maintaining essential payments system services.

The low-inflation environment clearly makes crisis management easier. For example, the Fed created a huge amount of liquidity following the 9/11 attacks, but doing so did not raise inflation fears. The Fed withdrew the extra liquidity as markets returned to normal; the Fed's handling of the crisis clearly reduced the impact of the event on the economy.

In the years ahead, should there be further crises, I believe it is reasonable to expect properly calibrated responses by the Fed. The lessons of experience have been thoroughly institutionalized in Federal Reserve practice.

EMPIRICAL UNDERSTANDING OF THE ECONOMY

Alan Greenspan has an astounding command of data. He has applied to raw data a deep understanding of economic theory and business practice and that understanding has enabled him to track economic developments in great detail. Greenspan's highly informed intuition has enabled him to adjust the stance of policy—the setting of the target federal funds rate—in timely fashion.

To some degree, Greenspan has institutionalized command over data in the Federal Reserve's staff, especially staff at the Board of Governors. Nevertheless, Greenspan's own expertise will be hard to match.

PREDICTABILITY OF MONETARY POLICY

The Greenspan years have seen a huge change in the conduct and transparency of monetary policy with the result that policy actions have become far more predictable to the market. When Greenspan took office in 1987, the Fed did not disclose policy actions on a current basis. Indeed, before 1987 Fed decisions were not only murky to the market but at times even murky within the System, including within the FOMC, as Daniel Thornton (2005) has documented. Moreover, before Greenspan many within the Fed believed that policy effectiveness depended on taking markets by surprise.

The evolution to greater transparency proceeded step by step during the Greenspan years. The most important single change was that the Fed began to disclose its decisions on the target fed funds rate in 1994. Besides disclosure of policy actions, two other features of the conduct of policy promoted transparency. One was that the FOMC adjusted the target fed funds rate in increments of 25 basis points and the other was that most adjustments occurred at regularly scheduled FOMC meetings. Poole and Rasche (2000) document the improved predictability of Fed policy actions.

Clarity of monetary policy has been enhanced by the general pattern of changes in the target federal funds rate. To make this point, consider policy actions in a pre-rational expectations optimal control framework. In such a model, the central bank would respond continuously to arriving information, adjusting the policy instrument by varying amounts depending on the nature of the information and frequently changing the direction of policy action. Such adjustments characterize aircraft autopilots, for example. During the Greenspan era the Fed has not adjusted the target federal funds rate in this fashion. A casual examination of the target funds rate series will

show long strings without change and long strings with changes in the same direction. Short-run reversals have been relatively rare. I believe that this pattern of adjustment probably enhances market understanding of the direction and purpose of policy actions, helping to improve the predictability of policy. When the central bank is predictable, it can be somewhat inactive as market responses carry much of the stabilization burden.

Starting with the policy statement following its meeting on August 12, 2003, the FOMC began to provide firm guidance as to the future direction of policy. The statement said that the Committee "believes that policy accommodation can be maintained for a considerable period." This language was repeated until the statement released on January 28, 2004, when the Committee said that it "believes that it can be patient in removing its policy accommodation." That language was continued until May 4, 2004, when the Committee said that it "believes that policy accommodation can be removed at a pace that is likely to be measured." At its meeting of June 29-30, 2004, the Committee raised the target federal funds rate by 25 basis points and issued a statement repeating the "measured pace" language. That language came to be interpreted in the market as creating an expectation of an increase in the target fed funds rate of 25 basis points at the next FOMC meeting and, depending on circumstances, at the next several meetings. At every subsequent meeting following the June 2004 meeting, through its most recent on June 29-30, 2005, the Committee raised the target funds rate by 25 basis points and repeated the "measured pace" language.

Providing guidance on likely future policy actions is a significant departure for the Federal Reserve. Historically, the Fed and other central banks have been reluctant to provide forward guidance out of a concern that doing so would limit freedom of action in the event of new information indicating that changed circumstances called for a change in policy direction. If the markets have a thorough understanding of policy, including an understanding that forward guidance is conditional on the information available to the central bank at the time the guidance is issued, then markets should not have difficulty in understanding how new information might require policy action that differs from the guidance.

Experience to date with forward guidance has been successful but in my opinion it is too early to tell whether this departure will be successful in the long run. The matter will be tested when changed circumstances require policy action that differs from forward guidance.

I believe that improved predictability of policy has had much to do with improved effectiveness of policy. Poole and Rasche (2000) argue that changes in policy practice have moved the economy toward a rational expectations macroeconomic equilibrium in which the Fed and the markets react in similar fashion to the arrival of new information. Synchronized responses between the markets and the Fed enhance the economy's adjustment to changed circumstances, thereby increasing economic stability and efficiency. In the years ahead, maintaining and extending improved predictability of policy will be a major challenge for Federal Reserve chairmen.

I've sketched some thoughts on four characteristics of the Greenspan regime. Given the economy's excellent performance during the Greenspan era, further study of the Greenspan regime should command a high priority among monetary economists. Understanding the sources of success will be critical to continuing success in future years.

REFERENCES

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